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**Social Networks, Rule of Law and Economic Growth in China:  
The Elusive Pursuit of the Right Combination of  
Private and Public Ordering**

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Global Economic Review, Vol. 31, No. 2, 2002

Research Paper No. 03-3

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**Social Networks, Rule of Law and Economic Growth in China: The Elusive  
Pursuit of the Right Combination of Private and Public Ordering**

Randall Peerenboom<sup>1</sup>

Although social networks exist in every society, they are widely believed to play a different and more prominent role in Asian societies, especially those with a Confucian heritage, than in Western states, particularly Western states with mature capitalist economies, liberal democratic political systems with robust civil societies, and well developed legal systems characterized by rule of law and a modern bureaucratic administrative system. This article explores the role of social networks in economic organization, development and growth. Clearly there are wide variations in the nature and role of social networks in Asia, which is to be expected given the wide diversity in Asian societies in terms of religious and cultural practices, political systems, levels of economic development and legal systems. Rather than attempting a broad comparison of social networks throughout Asia, my main focus will be on China, with reference to the experiences of other countries where relevant.

I consider the relationship of private ordering, networks of relationships and informal law to formal law and rule of law, taking up in particular the claims that the former are an adequate substitute for the latter and sufficient for sustained economic growth (or at least sufficient if combined with sound economic policies and favorable contingent factors such as political stability, adequate natural resources, an advantageous geographical location, etc.). The relationship between private ordering, social networks, informal law and economic growth has long been the subject of

controversy. While neo-classical economists struggled to explain the East Asian Miracle, others were quick to champion social networks, clientelism, corporatism and a rule of relationships as alternatives to rule of law and clear property rights. Although the Asian financial crisis took some of the wind out of the sails of the challengers to neo-classical economic theory, the subsequent quick turn around of many of the economies breathed new life into what appeared to be a settled debate, especially since the recovery was attributed in part to family and social networks. The high incidence of family businesses and the relational nature of much business in Asian countries appears to have helped cushion the shock of the Asian financial crisis by providing a social welfare network in countries where the social security system is typically weak, and by making it possible to raise capital to start over, thus contributing to a speedy economic recovery.

Notwithstanding the rapid return to health of some of the Asian economies, I shall argue that relationships, social networks and private orderings are not an adequate substitute for formal law and rule of law, and that the latter are necessary for sustained economic growth. Nevertheless, there is a role for private ordering, relational networks and informal law as complements to formal law. This is especially true during a transition period where markets are imperfect and institutions weak. But even in mature economies with well-developed institutions and rule of law, social networks, private ordering and informal law still play a complementary but nonetheless significant role.

## **Private Ordering, Relational Networks and the Legal System: Implications for the Implementation of Rule of Law and Economic Growth**

Advocates of rule of law and neo-classical economists alike have argued that sustainable economic development requires rule of law and in particular clear and enforceable property rights. Yet at first blush China seems to have had tremendous economic growth without either, leaving economists, political scientists and legal scholars to puzzle over the success of China's economy despite market and legal imperfections. China's phenomenal growth rate has been attributed to cultural factors (Weitzman and Xu 1994), a distinct form of "Chinese capitalism" (Redding 1990, Ghai 1993), a *guanxi*-based rule of relationships (Jones 1994), clientelism (Wank 1999) and corporatism (Walder and Oi 1999).<sup>2</sup> Chinese capitalism is characterized by a preference for family businesses, a tendency to resolve disputes through informal mechanisms rather than the courts, a common sinic cultural heritage, adherence to Confucian values, and an emphasis on relationships. Just as the key to Chinese capitalism is its emphasis on relationships and networks of familial, personal and social connections, so too relationships and connections lie at the heart of clientelist and corporatist theories.

One of the problems with these theories is that it is often not clear whether relationships, informal law and distinctively Chinese forms of capitalism are considered temporary second-best alternatives to formal law and rule of law that will give way once market reforms deepen and institutional failures, particularly shortcomings in the legal system, are addressed, or whether they are meant to be viable

long term alternatives. Similarly, it is often not clear whether relationships and informal law are meant to replace or merely complement formal law and rule of law. Carol Jones (1994: 212-13), however, is among the more explicit in suggesting that rule of law may not be required for economic development and that "informal alternatives to legal regulation may be more efficient than competitive markets based on law." In her view, the Four Dragons of Singapore, Taiwan, South Korea and Hong Kong have been dominated by a "rule of relationships" rather than rule of law and yet have enjoyed remarkable economic growth, leading her to conclude "formal rational law may not be quite as crucial to capitalism as Weber imagined."

The Asian financial crisis called attention to the dark side of excessive reliance on relationships, crony capitalism, non-transparent political, legal and economic decision-making processes and the lack of rule of law (Yusuf 2001; Jomo 2001). Nevertheless, as Asian economies have rebounded, some scholars have begun to question whether there wasn't some merit to earlier explanations for the East Asian Miracle and something of value to the distinctively Asian varieties of capitalism (Bell 2001; Jomo 2001: 473-76). To be sure, the nature and role of relationship networks and the legal order are not the only or necessarily even the primary factors in understanding economic growth in Asia. Others factors are arguably more important, including sound macroeconomic fundamentals and management; a stable business environment with low inflation; prudent fiscal policies; exchange rates to support exports; high savings and investment rates; high-quality human capital (good education and high literacy rates); merit-based bureaucracies; low income inequality; export promotion; success in

attracting FDI; political stability; and more controversially, a strong developmental state where a technocratic bureaucracy determines industrial policy, picking and choosing winners and in some cases deliberately “getting the prices wrong” (Yusuf 2001; Ito 2001; Amsden 1989).

### *The Argument for Private Ordering*

Even the staunchest defenders of formal law and rule of law allow that informal law and private orderings are likely to arise and serve a positive function where the formal legal system is dysfunctional or, as Ellickson (1991: 282) puts it, there are “more expeditious means for achieving order.”<sup>3</sup> Of course, the formal legal system is always dysfunctional to some extent. Porat (2000: 2461) observes that “parties will consider a public order ideal if the courts (and the enforcers of the courts’ decisions) enforce all contracts according to the substantive law preferred by the parties without incurring costs of litigation, with great speed and expertise, without bias, without mistakes, and without the parties incurring damages through the litigation proceedings.” He goes on to note that there is no need to conduct empirical studies to conclude that these conditions are never present in reality.

Dysfunctionality takes many different forms (Porat 2000; Hay et al. 1996). Judges may be incompetent, corrupt or biased. Given that court judgments may be unpredictable or unfair, parties may not want to gamble on litigation. Even where judges are competent, impartial and squeaky clean, they make lack all of the necessary

information to reach the right decision. Sometimes rules of evidence exclude certain evidence, for instance. While there are generally good reasons for such exclusionary rules, they may lead to a bad result in a particular case. Other times, judges or the jury may not know enough about a particular industry to reach the correct decision. The standard example is the difficulty of proving lost profits in the diamond industry. However, one need only consider the problems faced by juries or judges trying to sort out technical arguments in the Microsoft case or similar cases to appreciate that judges and juries may often find themselves out of their depth. Sometimes the substantive law is not what the parties want. The remedies may be limited. Or the parties may prefer strict application of the contract whereas the courts are compelled by statute or precedent to take into consideration course of business, good faith and other vague principles to reach an equitable result.

Moreover, the process of litigation can be costly, slow or harmful to the interest of the parties, resulting in reputational damage or damage to the relationship between the parties. Beyond the particular case, legal institutions may suffer from systemic weaknesses, as is the case in China (Peerenboom 2002). The PRC legislative system is still very much a work in progress. There is little opportunity for participation by those affected by legislation in the legislative process. As a result, there are many laws that are poorly drafted, riddled with inconsistencies or simply infeasible in practice. Worse yet, there are few practical ways of challenging inconsistent regulations. A weak administrative law system makes it difficult to challenge government decisions and rein in wayward officials who abuse their discretion. The judiciary lacks independence and

often the authority to challenge local governments and enforce judgments. Other actors in the system – lawyers, accountants, appraisers, regulators at securities commissions – are often unqualified and lacking in a firm sense of professional ethics and responsibility.

In some cases, the formal system may be able to respond, thus circumventing the need to rely on informal mechanisms and private ordering. For instance, judges and juries can overcome informational problems by relying on expert witnesses to explain the ins and outs of an industry. Where damages are hard to calculate in advance, parties may rely on liquidated damages clauses. Courts may also develop lenient standards for showing lost profits. Where the substantive law is problematic, parties may contract around it, at least within limits. Parties cannot evade mandatory clauses, and some of their preferred arrangements may be struck down as against the public order. Moreover, contracting around default rules requires lawyers and adds to the costs of transactions. Parties may overcome some of the difficulties in enforcing judgments due to the weakness of the courts by requiring payment in advance or third-party guarantees that may be more readily enforceable. The government may also reduce the hardship of high litigation costs for those without economic means by providing for legal aid or creating small claims courts.

Nevertheless, as no system will perfectly suit all of the needs of individuals, a private order may develop to address the shortcomings of the formal system. For example, arbitration allows commercial parties to resolve their disputes in private, thus protecting trade secrets and avoiding reputational damage. Arbitration also allows



parties to select their own decision-makers, thus avoiding corrupt and incompetent judges.

Similarly, reliance on social relationships and family connections reduces the transaction costs because parties connected in tight social networks need not bear the informational costs of conducting due diligence on the other party. Nor need they invest in high paid lawyers to draft lengthy contracts because they can rely on trust, loss of face and the threat of reputational damage to ensure contracts are performed. If a breach does occur, the parties can turn to informal means of resolving disputes, including mediation, that may be less expensive than litigation in court. Informal methods of resolving disputes may also result in more context-specific solutions that allow the parties to continue their relationship and thus serve their interests better than the kind of winner-take-all solution that a formal court might find. Private entities may also be more knowledgeable about particular industry or participants, and may not be limited by the same restrictive rules of evidence as courts.

In sum, a formal legal system that meets the standards of rule of law is costly to establish and operate. It would be prohibitively expensive to rely on the formal legal system to enforce all contracts. Thus, even in the litigious U.S., commercial disputes are regularly resolved without recourse to the court. In some cases, norms of generalized morality, social trust, self-enforcing market mechanisms and informal substitutes for formal law may provide the necessary predictability and certainty required by economic actors for a fraction of the cost. Reliance on such mechanisms promotes economic development by lowering the costs of doing business, both to the

state and to the parties. The savings may then be put to more productive uses.

### *The Shortcomings of Exclusive Reliance on Private Ordering*

As the economy grows, however, reliance on relationships rather than generally applicable laws and formal legal institutions becomes less effective. When the economy is small and the members of the business community closely related, it is easy to publicize a breach of contract and let others know that someone is not to be trusted. But as the number of transactions increases, it becomes more difficult to convey information about a particular party to all those that might have an interest in such information. Further, the transactions become more complex, making it difficult to rely on informal means of resolving disputes. As the amount in controversy grows, parties become reluctant to trust in the capacity of third parties without legal training to resolve disputes. There are also more transactions between parties with no connections beyond the particular transaction. In many cases, the parties may be complete strangers to each other, and not share an institutional superior or a mutually trusted third party that could mediate a dispute. A formal legal system is necessary to protect parties that are not repeat players or for whom the threat of withdrawing future business is not a sufficient deterrent to cause the other party to act in accordance with law. Consumer protection laws, for example, are needed to protect individual consumers against fraud because companies need not be concerned about one unhappy customer as long as there are many others. A “rule of relationships” also does nothing to prevent parties from

imposing externalities on outsiders. Predictably, one of the costs of economic development in China has been widespread environmental pollution.

Moreover, many of the informal mechanisms often cited as alternatives to rule of law are themselves dependent on the formal legal system to function. For instance, informal dispute mechanisms such as mediation are more effective when they are backed up by a formal legal system that will enforce judgments because the threat of taking the matter to court stimulates settlements and creates an incentive for the parties to honor the agreement.

The experiences of Asian countries tend to confirm that exclusive or even predominant reliance on relationships in China will not be sufficient to sustain long-term growth. Those who attribute the success of Asian countries to relation-based capitalism often underestimate the role law has played in economic development in the region, in part because they tend to elide rule of law with democracy and a liberal version of rights that emphasizes civil and political rights.<sup>4</sup> Of the Asian countries that have experienced sustained growth, most have enjoyed legal systems that comply with the standards of rule of law in their handling of commercial matters. Although the political regimes may not have been democratic and the legal system may not have provided much protection for civil and political rights in some cases, the Asian countries that experienced economic growth generally scored high with respect to the legal protection of economic interests. A survey of economic freedoms in 102 countries between 1993 and 1995 found that seven of the top twenty countries were in Asia (Rowen 1998: 7).<sup>5</sup> Of course, not all Asian countries have experienced rapid

growth.<sup>6</sup> Only six—Japan, South Korea, Taiwan, Hong Kong, Singapore and China—experienced sustained growth over 5% for the period from 1965 until 1995.<sup>7</sup> With the exception of China, the legal systems of the six countries that have achieved highest economic growth measure up favorably with the requirements of rule of law, particularly with respect to commercial matters. In contrast, the legal systems of the lowest performing countries are among the weakest in the region.

The data for Asian countries is consistent with the general evidence from other countries. Indeed, there is considerable evidence that rule of law is necessary if not sufficient in most cases for sustained economic development. A number of long-term, multiple-country empirical studies have shown rule of law and various aspects of a formal legal system to be positively correlated with growth.

Robert Barro (1996) analyzed data from 85 countries for the periods 1965-75, 1975-85 and 1985-90. He tested the impact of a number of independent variables, including rule of law. His rule of law index was based on International Country Risk Guide (ICRG) survey data compiled from the subjective responses of business persons regarding law and order. The law subcomponent assesses the strength and impartiality of the legality system and the order subcomponent assesses the popular observance of law. Higher scores indicate sound political institutions, a strong court system, and provisions for an orderly succession of power. Lower scores indicate a tradition of dependence on physical force or illegal means to settle claims. Barro's regression analysis found that an improvement in one rank in the 0 to 6 rule of law index raised growth rates by 0.5%.<sup>8</sup>

Other studies have found that clear and enforceable property rights are positively correlated with growth. Knack and Keefer (1995) relied on both the ICRG and the Business Environmental Risk Intelligence (BERI) surveys. The BERI survey does not directly ask about rule of law but includes questions about contract enforceability, the likelihood of nationalization, infrastructure and bureaucratic delays. Knack and Keefer conclude that institutions that protect property rights are crucial to economic growth and investment and the effect of such institutions continues to exist even after controlling for investment.

In a somewhat broader study, Clague, Knack, Keefer and Olson (1997) tested growth rates against the BERI standards; the contract-intensive money ratio (CIM), which is the ratio of non-currency money to total money supply;<sup>9</sup> and the aggregate ICRG index, which is a composite of the indexes for the quality of the bureaucracy, corruption in government, rule of law, expropriation risk, and the risk of government repudiation of contracts. Higher ICGR, CIM and BERI scores were associated with higher annual per capita growth rates, even in less developed countries.

Another study based on the ICGR showed that rule of law is an important factor in determining the size of capital markets (both debt and equity) and that improvements in rule of law are associated with more domestically listed firms and initial public offerings per capita, a greater ratio of private sector debt to GNP, and a higher amount of outsider participation in a country's capital markets.<sup>10</sup> In a similar vein, Ross Levine (1999) found that countries that give a high priority to creditors receiving the full present value of their claims in bankruptcy or corporate reorganizations and in which

the legal system effectively enforces contracts generally have more developed financial intermediaries and higher growth rates. Moving a country from the lowest quartile of countries with respect to the legal protection of creditors to the next quartile translates into a 29% rise in financial development, which increases growth by almost one percentage point a year.

Still another study of seventy countries found that the "efficiency and integrity of the legal environment as it affects business, particularly foreign firms" was positively and significantly correlated with economic growth, even controlling for GDP per capita. It also found that, contrary to the speculations of some academic theorists that corruption might increase economic growth, corruption lowers private investment, thereby reducing growth rates.<sup>11</sup>

Whatever the advantages of close ties to government officials, clientelism hurts companies that are more economically efficient but lack the proper connections. Government officials allocate inputs and financing to maximize the benefits they receive from the patronage. Analytically, companies can be divided into four types. The first type could not survive in a competitive market solely on the basis of the quality and price of its products or services. Its survival depends on *guanxi*. The second type has connections but does not need to rely on them to survive and do well in a competitive market. The third type could do well in a competitive market but lacks *guanxi*, so is driven out of business in the existing imperfect market that is dependent on connections. The fourth type is not well-connected but nonetheless is able to survive and succeed in the current market. It might be able to do even better in a market less

dependent on connections, but not necessarily.

From a social perspective, categories one and three represent social loss. All else being equal, more efficient companies produce more for society at cheaper prices. Society loses the benefit of efficient but *guanxi*-poor category three companies entirely because they are not able to survive without connections. The costs of relying on connections for category one companies are passed on to the consumer and society in the form of lower quality and/or higher priced products or services. The cost may not be entirely dead weight loss. There may be some benefits of relying on *guanxi*, some social grease as it were. For instance, low-paid but highly qualified and competent officials might leave government if they were not able to take advantage of free dinners and trips paid for by companies. But surely there are more efficient and equitable ways to compensate officials and allocate resources than through an indirect tax on consumers. Category four companies also represent a loss to society, at least to the extent that the companies would be able to do even better in a market less dependent on connections.

*The Limits of Clientelist and Corporatist Affective Social Networks and the Need for a General Ethic*

Although affective social networks are themselves a form of social trust and capital, they are also at odds with the creation of more generally applicable social norms and hence the possibility of a more robust form of social trust and capital built on a common

conception of the good. Following Weber, Platteau (1994a, 1994b) has argued that the creation of norms of generalized morality depends on a society's cultural beliefs and philosophical and normative traditions. A culture of honesty or trust requires: (i) a large number of people who have a preference for honesty to start with; (ii) they also have sufficient trust in others' predisposition toward honesty; (iii) their bent for honesty is strong enough not be easily discouraged by bad experiences while it is easily reinforced by good experiences; (iv) cheaters are subject to strong guilt feelings; (v) honest people are willing to sanction breaches of honesty conventions even when their own interests have not been harmed by the observed breach. The fulfillment of these conditions requires other-regarding norms. For such an other-regarding morality to work as the basis of market economy, there needs to be a generalized ethic where one puts oneself on similar footing as others or shows concerns for others. The other-regarding ethic must be sufficiently broad so as to encompass those that are part of a large, modern economy, including those outside one's own kinship and immediate social group. Weber maintained that one of the achievements of Judeo-Christianity was to shatter that fetters of the kin. However, this did not happen in China because of Confucianism's relational ethics of graded obligations, which leads to attenuated concern for others as one becomes increasingly removed from the family. More generally, Western ethical traditions have tended to universalize ethical obligations (Christianity's emphasis on fraternity and the inherent dignity of all of God's creatures; Kant's categorical imperative; utilitarianism's maximization principle that assigns the same weight to the utility preferences of all persons; civic republicanism, with its emphasis on a



public-spirited commitment to the common good). In contrast, the role-sensitive Confucianism ethics is based on particular relationships between the parties.

Where you have clientelist ties, Platteau (1994b: 779) concludes:

No universally shared social ethic can exist. Codes of conduct are governed by a limited-group morality which emphasises the strength of ties to close social relations; procedural norms, when they exist, are particularistic; professional standards are low; reward and sanction mechanisms (including litigation) as well as taxation and subsidies are meted out in a specific way so as to make patronage effective; wealth is currently acquired or redistributed through trafficking, racketeering, plundering, looting, or favouratism, all practices which are almost always accomplished within the purview of the political power structure (at the level of the presidency, the politico-military hierarchy, the top civil servants, the ruling party officials and so on).

Clientelist social networks are more likely to divide than to unite. By subverting general social norms, they hinder the development of a common conception of the good thought necessary by Tocqueville to complement the market and sought by Confucian communitarians as the basis for a flourishing society.

In modern pluralistic societies, a thin rule of law often provides the basis for a common ethic, albeit a more procedural than substantive ethic.<sup>12</sup> Yet social networks are likely to undermine rule of law and obstruct its development and implementation.

To be sure, vertical clientelism and corporatism are in some ways compatible and in other ways at odds with rule of law. It is normal for business people to seek close relations with the government. That happens everywhere. But such relationships have their costs and may lead to results that are inconsistent with rule of law. Decision-making based on particularistic relations may violate the rule of law requirement that publicly promulgated, generally applicable laws be fairly and impartially applied. When parties can rely on their relations with government officials for approvals, they may need to worry less about whether they comply with the legal requirements. Yet government officials who treat a family member or a classmate like any other person would be thought to be lacking in human feeling (*renqing*). The salience of connections and the "economy of gift-giving" puts pressure on administrative officials to bend the rules.

Government officials are not the only ones subject to social pressures. Entreaties from relatives, friends and acquaintances are a major source of outside interference in judicial proceedings, and much more common than interference from the Party. Judges often find themselves besieged by intermediaries seeking to intervene on behalf of a criminal suspect or one of the parties in a commercial dispute. After the arrest of one particular individual, police had to post a sign on the door of the station saying "those who come to appeal to our sympathy (*jiang renqing*), stop" (Fu Hualing 1994: 286). Yet judges who refuse to at least listen to their friends and family will be considered to lack human feeling and run the risk of being social outcasts.

Corporatist arrangements in which the local government is involved in running

local businesses also often run afoul of rule of law requirements. The loser is typically the state. National laws regularly give way to local interests. Local governments offer unauthorized tax breaks to companies that deprive the center of revenue or reduce the profitability of companies by collecting fees that go into local off-budget coffers. Government officials siphon off state assets to set up spin-off companies, leaving the state holding unproductive assets and saddled with liabilities.

But the state is not the only one that suffers from the lack of generally applicable laws and rule of law. Non-state actors also suffer. Local government involvement in business is one of the major causes of the widespread regionalism and local protectionism. Local governments seek to protect local companies from outside competition through the erection of trade barriers. Litigants from outside the region have a difficult time winning cases against powerful local companies. Even if they win, they often cannot get the local court to enforce the judgment. Clientelism also opens the door for corruption and rent-seeking. Administrative departments use their licensing power to create administrative monopolies or to extract rents from applicants.

At a more fundamental level, corporatism and clientelism undermine rule of law by diminishing respect for the law and debasing the courts, legal professions and other professions necessary to realize rule of law. There is little point in relying on the courts when local governments are the only ones able to compel performance or enforce contracts. Lawyers need not sharpen their legal skills when cases turn on connections rather than legal arguments. Accountants and appraisers need not hone their appraisal techniques when the value of the asset is to be determined by governments officials

colluding with others to ensure a low price in exchange for kickbacks, an equity share in the newly formed company or other material benefits.

*Private Ordering versus Formal Law: Implications for Democracy and Legitimacy*

Katz (2000: 2481) suggests that “democratic public-order institutions, when accompanied by public-order norms of transparency and accountability, offer processes and policies of greater legitimacy and fairness than can private order institutions.” Decision making is subject to procedural requirements. There are often more opportunities for participation in the decision-making process. While civic republicans and others view citizen participation in government as intrinsically valuable, it is also instrumentally valuable in that it tends to increase the legitimacy of the regime and particular legal rules, thus reducing the costs of enforcement as citizens are more likely to comply voluntarily with the law (Tyler 1990). Indeed, village elections were supported in China in part because of the problems of Party leaders in getting villagers to comply with their regulations. Now that villagers have a greater say in determining the regulations, compliance has improved, and tensions between villagers and the Party has reduced, at least in some villages. Kelliher (1997: 73-74) cites as examples better fulfillment of grain quotas, fewer under-age marriages, reduced backlog of uncollected fees, more taxes paid and more women sterilized.

Although democratic elections are limited in China to the village level, the regime could still bolster its legitimacy by emphasizing rule of law and the public order over

private ordering and corporatism. In the absence of democracy, the formal legal system serves as a safety valve for social pressure. For instance, with labor disputes on the rise, the government has taken steps to strengthen formal channels for resolving such disputes and to prevent laborers from relying on more economically and socially disruptive means such as work stoppage, strikes, demonstrations, violence and political movements.

Having raised expectations by instilling in people a heightened consciousness of their rights and holding out the promise of rule of law and legal remedies for their problems, the ruling regime must make good on its promises or suffer a backlash. In recent years, villagers have frequently engaged in widespread protests, which on numerous occasions have ended in violence. Angry villagers have burned government buildings and beaten, even killed, government officials, including tax collectors. Although there are many reasons why villagers are pushed to such extremes, widespread protests are attributable in no small measure to the lack of other effective remedies, including legal remedies.

Nowadays, many people rely on petitions to government officials to redress wrongs, even though such petitions are rarely effective, particularly without media exposure to pressure government officials to act. They do so in large part because other channels for challenging government decisions remain weak. Strengthening the administrative litigation, administrative supervision and administrative review systems would increase accountability and decrease the need to rely on connections to government officials, while enhancing the legitimacy of the regime. Similarly, there

are many ways in which the law-making and administrative rule-making procedures could be opened up to allow for greater transparency, citizen participation and accountability. The recently passed Law on Legislation has in fact allowed for greater participation by the public, requiring in some instances hearings. China is also currently drafting an Administrative Procedure Law that will increase opportunities for public participation and give citizens additional grounds for challenging administrative decisions.

The government's impressive efforts over the last twenty years to strengthen the formal legal system suggests that China's leaders appreciate the important role of formal law and rule of law for economic and social justice. Nevertheless, much remains to be done to improve the system. In the meantime, people will continue to rely on private ordering and clientelist relationships.

## **Conclusion**

Formal and informal law, public ordering and private ordering, reliance on relationships and rule of law are complementary in many ways. Family businesses, networks of personal relationships, private orderings exist in all legal systems, although the cultural, economic, political and economic context may vary from one country to the next, leading to differences in the degree of importance or variations in particular practices. Since they are not perfect substitutes, each can support and help overcome the weaknesses of the other. The formal legal system, for instance, can deliberately

encourage the development of the private order by steering parties to mediation, as was the case under China's Civil Procedure Law until it was amended in 1991. Even today, parties are required to try to settle labor disputes through arbitration before going to court.

The trick of course is to determine when each type of ordering is best. Some cases are relatively clear. Formal laws are often required to ensure that the private order does not violate public norms and goals. When the formal legal system is weak and incapable of enforcing judgments, private mechanisms such as collection agencies (often run by a mafia-like criminal organizations) that rely on threats and violence may arise (Milhaupt and West 2000). The formal criminal law system is required to outlaw and curtail such activities. Similarly, antitrust laws prevent price collusion by members of trade associations; anti-discrimination laws prevent exclusion and discriminatory practices; and technology forcing laws compel companies to internalize externalities.

In some cases, empirical research can shed light on which institutions and practices are more efficient or normatively attractive. For instance, McMillan and Woodruff (2000) found that business networks complement the formal system whereas social networks tend to be a substitute. But ultimately perhaps the best indicator of what works best will be the market.

Pistor and Wellons' study of the relationship between law and economic development in China, Taiwan, Japan, South Korea, Malaysia and India found that between 1960 and 1995, in five of the six countries, the exception being Malaysia, the trend was to become more market-oriented (as opposed to state-allocative) and more

rule-based (as opposed to discretionary).<sup>13</sup> They found that economic development and reforms exposed weaknesses in laws and legal institutions, leading to changes in the formal legal system. But changes in the economy also exposed weaknesses in the informal mechanisms for securing contracts and resolving disputes, thereby increasing reliance on the formal legal system and correspondingly increasing demand for changes in the formal legal system.

Their study looked at four specific areas: dispute settlement, business governance and capital formation, credit and security, and administrative litigation. In each area, there were signs of convergence with Western countries, though to different degrees. With the exception of Japan, all countries in East Asia, including China, witnessed a rise in litigation at the expense of mediation as the economy developed and became more market-oriented. Moreover, as the private sector grew, corporate form became more important. Significantly, family businesses tended to encounter greater difficulties in raising capital, putting them at a competitive disadvantage with other companies. Outside investors may be reluctant to buy into companies that are tightly controlled by family members, particularly in the absence of strong minority shareholder protection provisions. Indeed, the weaknesses (as well as the strengths) of the Chinese form of capitalism and family businesses are well known (Redding 1990; Jomo 2001; Pistor and Wellons 1999). Thus, some predict that family businesses will become less important as a result of increased competition from globalization and market reforms (Kuo 1991).

Although there was not enough data to draw firm conclusions in the Pistor and



Wellons study about the relative importance of formal law versus reliance on social capital and trust in forming, securing and implementing contracts, it was clear that as markets became more important, so did the need for effective security mechanisms. Conversely, relational lending in which the creditor and borrower share a formal ownership relationship decreased over time. At any rate, substitutes for security interests themselves relied on formal law (Pistor and Wellons 1999: 16).

In China, the transition to the market economy has provided ample opportunities to take advantage of one's connections. But while some scholars see the importance of *guanxi* as increasing (Yang 1994), others see it as decreasing due to the emergence of a formal legal structure and a market economy (Guthrie 1998; Kung 1999). The market makes it unnecessary to rely on connections in many situations. Often it is simply easier and more convenient to obtain what one wants by paying for it. The strengthening of the legal system also makes it more difficult and risky to rely on connections to circumvent legal requirements. Similarly, the dramatic reversal of the fortunes of TVEs raises doubts about the benefits of clientelism, and supports the view that clientelism is to a large extent a short-term reaction to an undeveloped and immature market economy and weak legal system. Further, the trend toward privatization supports the thesis that clear property rights and a legal system capable of enforcing them are critical for sustained growth. Indeed, there is considerable support for the prevailing view among economists that clientelism, corporatism and vague property rights offer advantages during a transitional period but are nonetheless suboptimal. As market and legal reforms progress, they become less beneficial (Li

1996; Kung 1999; Che and Qian 1998; Woo 1999).

In sum, although the optimal balance of formal and informal systems may be difficult to determine, what is clear is that while relationships and informal means of resolving disputes may complement the formal legal system, they are at best partial substitutes for rule of law and the formal legal system. Moreover, while guanxi networks and clientelism will always exist in some form and to some degree, they are likely to change and become less important over time as economic reforms deepen and institutional failures are addressed.<sup>14</sup>

As noted, however, guanxi networks are only one aspect of what makes East Asian varieties of capitalism distinctive. Nor is it a question of all systems converging on identical institutions and practices. Given the different cultural, economic, political and legal starting points of various countries and the path-dependent nature of reforms, it is unlikely that any two systems will be exactly alike. Depending on how closely one looks, one can find ample variety among the forms of capitalism in advanced Western states, notwithstanding a general framework of similar institutions and practices (Hollingsworth and Boyer 1999). Thus, many features of “East Asian capitalism” may still be worth maintaining, particularly given the current context in some Asian countries. Indeed, some features of East Asian capitalism might be beneficially adopted by Western states, such as a longer term view regarding profits, more emphasis on the impact of businesses on local communities, a stronger role for the government in coordinating research and making the results publicly available so as to increase the effectiveness of coordination among firms, greater attention to an egalitarian

distribution of wealth, and the promotion of the family through the adoption of workplace rules and government supported childcare programs (Bell 2001). Of course, to some extent the outcome on these issues turns not just on economic efficiency but fundamental values that determine just what type of society one prefers to live in.

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<sup>2</sup> One of the problems with this argument is that it is impossible to determine how high growth rates might have been had the legal system been rule of law compliant. For a discussion of this and other possible explanations of the seeming paradox, see Peerenboom (2002).

<sup>3</sup> Ellickson (1991: 283) argues that members of a close-knit group tend to develop norms that maximize the objective welfare of group members (but not necessarily of society more broadly), and that people often choose informal custom over law not only because the custom is administratively cheaper but also because the content of the norms is likely to be welfare maximizing. Nevertheless, he concludes reasonably enough that norms have their

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limits and law has its place.

- <sup>4</sup> For the argument that law played a greater role than normally suggested, see Pistor and Wellons (1999), Ravich (2000); Ramseyer and Nakazato (1999).
- <sup>5</sup> Economic freedoms include protection of the value of money, free exchange of property, a fair judiciary, few trade restrictions, labor market freedoms and freedom from economic coercion by political opponents.
- <sup>6</sup> Rowen (1998: 2) cautions that there is no single model of East Asian development. East Asian countries started in different places, grew at different rates, under different types of political regimes, and using a variety of policies.
- <sup>7</sup> Thailand, Malaysia, Indonesia grew more slowly, at around 3.5% per year. Seven countries, including North Korea, Mongolia, Vietnam, Cambodia, Laos, Philippines and Myanmar, averaged less than 2% growth. *Id.* Growth rates in Thailand, Malaysia, Indonesia and Vietnam increased during the 1980s and 1990s up until the financial crisis.
- <sup>8</sup> Barro (1997: 28).
- <sup>9</sup> The idea is that in societies where property rights are secure and contracts can be reliably enforced, parties have little reason to use cash for large transactions or to maintain large cash holdings.
- <sup>10</sup> La Porta et al. (1997). Demirguc-Kunt and Maksimovic (1998) also found that companies are more likely to fund growth through external financing in countries that score high on the ICRG index for Law and Order.
- <sup>11</sup> Mauro (1995). A World Bank Study of 4000 business persons in 69 countries supports the Mauro study's conclusion that corruption inhibits investment and thus leads to lower growth rates. Corruption was cited as one of the three most important obstacles to growth in less developed countries though not in Asian countries and one other region dominated by transition economies. See Brunetti et al. (1998).
- <sup>12</sup> I argue elsewhere (Peerenboom 2002) that the differences in fundamental values and substantive moral views that separate statist socialists, neo-authoritarians, communitarians and liberal democrats make it unlikely that thick rule of law will provide a sufficiently robust conception of the common good to fill the moral vacuum that exists in contemporary China. Rather, the legal system will be a situs where the various conceptions of the good compete.
- <sup>13</sup> Pistor and Wellons (1999). Interestingly, several Asian states relied on discretionary state intervention to overcome the financial crisis. The government in Hong Kong, for instance, intervened to prop up the stock market and the value of the Hong Kong dollar. The Malaysian government imposed capital restrictions. In South Korea, a newly created government agency, the Financial Supervisory Commission, oversaw reforms of the financial sector, securities markets and corporate governments, often drafting laws and regulations without input from lawyers in public or private practice, which were then passed by the National Assembly with only marginal modifications. The FSC also relied

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on a number of internal guidelines that probably are not subject to judicial review.

<sup>14</sup> Wilson (1997) notes that while there is still an affective or social dimension to much gift giving, even in semi-urban areas, such as the area around Shanghai that he studied, the market economy changed guanxi practices in at least four ways: (i) people tend to give money more rather than exchanging labor (such as help in building a house); (ii) greater wealth and the ease of calculating the value of cash gifts is leading to “one-upmanship” rather than reciprocity; (iii) there is a trend to hire out nasty jobs rather than expecting friends to pitch in; (iv) as costs increase, for example, for new housing, loans are larger and tend to come from one’s family, rather than other villagers or even one’s closest friends.